

BRIEF IN SUPPORT OF PETITION.

I. Opinions Below.

The opinion of the Circuit Court of Appeals is reported in 128 F. (2d) 986, and appears on pages 67 to 75 of the Record.

The opinion of the Board of Tax Appeals has not been reported. It appears on pages 32 to 36 of the Record.

II. Jurisdiction.

This Court has jurisdiction under section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

III. Statement of the Case.

The petitioner's by-laws, providing for equal division of its capital stock into Pinkham stock and Gove stock, respectively, make a substantially equal division of offices between those who hold, and are nominated by holders of, Pinkham stock on the one hand, and those who hold, and are nominated by holders of, Gove stock on the other (R. 68-69, 33, and By-Laws, Exh. 1).

In general conformity with this division of duties, the by-laws provide that the total compensation of officers or directors holding or beneficially interested in Pinkham stock shall always be equal to that of officers or directors holding or beneficially interested in Gove stock (R. 69). They further provide that—

“the aggregate compensation or salaries received by officers of the company who are holders of or beneficially interested in the Gove stock shall be apportioned among such officers as shall be determined by

a vote of the Gove directors. The aggregate compensation or salaries received by the officers of the company who are holders of or beneficially interested in the Pinkham stock shall be apportioned among such officers as shall be determined by a majority of the Pinkham directors" (R. 69).

The total compensation of the Gove officers and directors, and of the Pinkham officers and directors, was fixed by the Board of Directors (R. 69). The evidence was undisputed that this amount had been fixed by the Board after successive increases, in step with increases in the volume of the petitioner's business (R. 48). None of these individuals received any compensation except their respective portions of such total compensation (R. 47, 57, 61). In each of the years 1936 and 1937 the portions allocated to Aroline P. Gove and Lydia P. Gove by the Gove directors amounted to \$21,000 and \$8000, respectively (R. 69).

Under these circumstances the Commissioner allowed no deduction for either Aroline P. Gove or Lydia P. Gove, except the \$1000 paid to them as directors (R. 70, 69). The Board of Tax Appeals, in determining the fairness or unfairness of the salary of each, compared it with the amount which happened to be allocated in the same year by a majority of the Pinkham directors to individual Pinkham officers (R. 36). The Circuit Court of Appeals held that this comparison was proper (R. 71); that "we do not have before us a set of facts in which the principle of group compensation, assuming without deciding its validity in some instances, is applicable" (R. 72); and that "the burden was upon the petitioner to show what Aroline and Lydia actually did, and the difficulty of the Board in segregating their activities bears heavily against it" (R. 73). The Circuit Court of Appeals therefore affirmed the decision of the Board of Tax Appeals (R. 75).

IV. Specification of Errors.

The Circuit Court of Appeals erred—

1. In refusing to recognize and apply to this case the principle that reasonable compensation for personal services actually rendered may be deductible when paid to a group as such, as total compensation for the services of all the individual members of the group.
2. In confusing group compensation with group service; and in concluding, from the fact that the duties of each individual member of the group were defined, that the total compensation was not paid for services of the group as such.
3. In basing its decision upon the theory that, where a group of persons is compensated for all of the services rendered by its individual members, and the right to that total compensation is then subdivided among them by members of the group at their own pleasure, without necessary or suggested reference to the value of their respective services—
 - (a) The failure of the petitioner to segregate the services of each member of the group from those of each other member “bears heavily against it”; and
 - (b) A comparison of the amounts similarly allocated and paid to the members of a different group of employees of the same petitioner, by the members of that group, also without necessary or suggested reference to the value of their respective services, is relevant and important, and warrants an inference as to the value of the services of individual members of the former group.

V. Summary of the Argument.

Reasonable compensation paid for the total personal services actually rendered by a group of persons is de-

ductible as an ordinary and necessary expense in determining taxable net income; for personal services of one individual do not cease to be such when another person serves with him. Nothing in the statute, treasury regulations nor decisions militates against the deductibility of such group payments when actually made.

By virtue of the petitioner's by-laws, the payments here made were for services of two groups of officers and directors as such. This was not altered by the fact that their individual duties, as distinct from their individual compensation, were defined by the corporation. Under the by-law the group determined the ultimate apportionment and disposition of this group compensation for personal services at its pleasure, without necessary or suggested reference to the value of the services of the respective assignees; so that the payments actually made by the corporation had to be, and were, made in accordance with these allocations. The amounts so paid, however, remained portions of group compensation for personal services of the group. The compensatory character of the whole, and therefore of all its parts, remained unchanged by the apportionments, or by the lack of relation of the several portions to the value of services of the respective assignees, or by the act of the petitioner in making payments accordingly.

The Board of Tax Appeals rejected the principle of group compensation as applied to this case. The Board treated as of primary significance a comparison of the portions of the total compensation arbitrarily allocated by the Gove group, and therefore ultimately paid by the petitioner to each of the Gove officers concerned, with the portions so allocated by the Pinkham group and therefore ultimately paid by the corporation to the individual Pinkham officers; and labored to segregate the services of each of the Gove officers from those of each of the others, so as

to determine whether their individual services were fairly worth the amounts allocated to them. The Court confirmed the propriety of these attempted comparisons, and held that the Board's difficulty in segregating services of each of the Gove officers from those of each of the others "bears heavily against" the petitioner. Therefore, in their whole approach to the problem presented by this case, as well as in the factors primarily involved in its decision, the Board and the Court were in error, and the rights of the petitioner on the facts and law have not been rightly considered.

This case, being one of actual group compensation for personal services, is believed to be of first instance. An enunciation of the principles applicable to the deductibility of such compensation will not only ensure to this petitioner the proper consideration which its problem is believed to merit and has not yet received, but also, in providing guidance in this uncharted realm, will serve the public interest.

VI. Argument.

1. Reasonable compensation paid for the total personal services actually rendered by a group of persons is deductible, as an ordinary and necessary expense, in determining taxable net income.

Services of one person do not cease to be "personal services" when another person serves with him. Nothing in the statute, in the regulations (Appendix, p. 18, below) nor in their obvious purpose suggests that joint compensation in reasonable amount for services rendered by two or more persons is not deductible, or that in such case the employer seeking to justify such compensation can be in any way prejudiced by the failure to segregate the services actually rendered by each individual member of the group. These statutes are to be construed liberally in

favor of the taxpayer (*United States v. Updike*, 281 U.S. 489, 496).

Treasury Regulations 94, Art. 23 (a)-6:

"The test of deductibility in the case of compensation payments is whether they are reasonable and are in fact payments purely for services * * * The form or method of fixing compensation is not decisive as to deductibility."

In cases like *L. Schepp Co.*, 25 B.T.A. 419, 429 (cited by the Circuit Court, R. 36), and *Crowley Brothers, Inc.*, 2 B.T.A. 477, 479, the Board has held that it is ordinarily the value of individual services, not of group services, which must be considered. But those cases were completely different from this one, for in them the officers and employees were not in fact compensated as a group. Although each officer and employee was employed and compensated separately by the company, the taxpayer tried to justify the compensation of one officer by the justice of the total compensation of all, on the ground that the statutory allowance of a deduction for "reasonable . . . salaries" allegedly meant only a reasonable aggregate of salaries, and that an inquiry into individual salaries was therefore irrelevant. So strained a construction of the statute clearly merited the rebuff which it received. But the situation there presented had nothing in common with that in the present case, where the corporation by its Board of Directors fixed only the total compensation of the group, and was required to pay this total in portions allocated by members of the group without any necessary or suggested reference to the value of services rendered by each individual recipient.

2. The petitioner compensated its Gove officers and directors as a group. The deductibility of the petitioner's

payments to Aroline or Lydia Gove was therefore not to be judged by the value of the services capable of segregation on the evidence as solely and individually rendered by her, and could not be impaired by difficulty in making such segregation, nor by comparison with payments so made to members of the same or other groups of petitioner's employees.

The by-law provides that "the aggregate compensation or salaries received by officers of the company who are holders of or beneficially interested in the Gove stock shall be apportioned among such officers as shall be determined by a vote of the Gove directors" (R. 69). The aggregate annual compensation of Pinkham and Gove directors, which then had to be equally divided between the two classes, was fixed by the Board of Directors for the tax years and certain prior years at \$60,000 (R. 69). Thus, so far as the corporation was concerned, the compensation was joint. It was not rendered any the less so by the definition of the duties of each individual member of the group. The Circuit Court confused group service with group compensation. Its conclusion (R. 72) that this was not a case of group compensation, because the duties of each member were separately defined, is a clear *non sequitur*. It is precluded, not by an "afterthought" (R. 72), but by the necessary construction of this by-law and the act of the corporation. The duties of Aroline and Lydia Gove and others, though separately defined, were compensated altogether by one sum, the allocation of which to them was determined wholly by the group of which they were two-thirds of the members (R. 69, 49), and was no concern of the corporation, which was obliged to and did pay out the total sum in accordance with the amount so allocated, and reported them in its income tax returns accordingly (R. 57, 61). The portions so paid did not, and were not intended to, measure the value of the individual

services separately rendered by the individual recipients respectively. But they were portions of a larger amount, paid as compensation, for personal services actually rendered by the group, namely, the Gove officers and directors, of which they were members.

Thus the segregation of the services rendered by each member of the group would have been inconsequential and futile; and the Court's holding (R. 73) that the difficulty of the Board in making this segregation "bears heavily against" the petitioner was unsound and unjust. That the holding was prejudicial to the petitioner the Court itself declares.

It was the same fallacy of the Board and of the Court which led them to treat not only as of importance, but as of primary importance, a comparison of amounts allocated by the Gove directors to individual Gove officers with those allocated by a majority of the Pinkham directors to individual Pinkham officers. Such a comparison would be pertinent only if the amounts of these individual payments were determined by the corporation as in conformity with its determination of the worth of the services concerned—an assumption devoid of any foundation in this record. It is the fallacy of one comparing amounts paid to one assignee with those paid to another, and basing an opinion as to the value of their respective services, on the amounts so assigned, not by the employer, but by the employee-assignor.

3. Controlling inferences expressly drawn by the Board, and confirmed by the Court, were wrong, entitling the petitioner to redress.

The action of the Circuit Court of Appeals, above discussed, may be viewed from an angle different from that above presented, but with the same result. It was in evidence that Arthur W. Pinkham was paid by the petitioner

only \$15,000 a year, this being the portion of the total compensation of \$30,000 allocated to him by a majority of the Pinkham directors. This evidence warrants no inference as to the opinion of the value of his services entertained by the petitioner, nor by the allocators, *i.e.*, a majority of the Pinkham directors. In the opinion of either, his services might well have been worth much more than that. The Board of Tax Appeals inferred that, because he was so allocated and paid only \$15,000, his services had only that value; and that the services of Aroline P. Gove, older than he, and absent part of the year, could not have been worth nearly so much; and the Circuit Court of Appeals emphatically confirmed the propriety of those unwarranted inferences.

With respect to decisions of the Board of Tax Appeals, the Circuit Court of Appeals for the First Circuit held, in *Conrad & Co. v. Commissioner of Internal Revenue*, 50 F. (2d) 576, at 579:

"In a review of the decision of the Board of Tax Appeals by this court, only questions of law are open. Its findings of fact are not reviewable, and unless it finds facts without evidence, no question of law is presented. If, however, it draws inferences not warranted by the facts found, or makes erroneous applications of law, its decisions are open to review and may be reversed, or modified by the court or remanded for the purpose."

See also—

Rhode Island Hospital Trust Co. v. Commissioner (C.C.A. 1, 1928), 29 F. (2d) 339, 341.

Heywood Boot & Shoe Co. v. Commissioner (C.C.A. 1, 1935), 76 F. (2d) 586.

Grand Rapids Store Equipment Co. v. Commissioner (C.C.A. 6, 1932), 59 F. (2d) 914, 915.

The principle of the opinion just quoted is applicable, not only to the opinion of the Board of Tax Appeals in this case, but also to that of the Circuit Court of Appeals itself. The inferences drawn by the former tribunal from the facts in evidence, and held justified by the latter, are not only unwarranted, but reveal a basically wrong approach to the only question presented for their decision.

The error in drawing an unwarranted inference from the facts is not unlike the error in wrongful admission of evidence, as to which this Court has held:

“It is elementary that the admission of illegal evidence, over objection, necessitates reversal.”

Waldron v. Waldron, 156 U.S. 361, 380; 39 L. Ed. 453, 458.

Such reversal is necessitated because it is impossible to determine the relative weight accorded by the lower Court to the wrongfully admitted evidence.

Wigmore on Evidence (3d ed.) sec. 21.

Ellis v. Short, 21 Pick. 142, 144.

Legman v. United States, 295 Fed. 474, 477 (C.C.A. 3).

In this case, however, the degree of importance attached by the Board and the Court to the amounts allocated and paid to individual members of the Pinkham group, for purposes of comparison, is not left to conjecture, but is declared and emphasized in their opinions (R. 36, 74). But for this inference, the undisputed evidence of Arthur W. Pinkham (R. 50) and of the expert witness (R. 52-54) as to the worth of the services of Aroline and Lydia Gove might well have been deemed controlling. For the Circuit Court to conclude that the Board of Tax Appeals would not have deemed it so would

be to violate the very rule which the Court enunciates (R. 75), that—

“The Court may not substitute its view of the facts for that of the Board.”

Wilmington Trust Co. v. Helvering, U.S. ;
86 L. Ed. 908, 911.

4. The subdivision of the group compensation, by members of the group, without reference to services, did not affect its deductibility.

Where such total compensation for personal services is subdivided by those entitled to receive it, and such subdivision need not and does not purport to be based on the value of their respective services, and the total compensation is then paid by the employer in accordance with these allocations, the deductibility is not thereby affected. It remains dependent solely on the value of the total services rendered by the group. In that case the deductibility of the part depends on the deductibility of the whole. The employer's right to deduct a payment for compensation cannot be affected by its compliance with a legal assignment by the person or persons entitled to receive the amount paid.

That the payments were for the purpose and in the nature of compensation is believed not to be in dispute. These officers received no other compensation for their extensive services. The payments were designated as “salaries” and “compensation” in the by-laws. They were not made in accordance with their individual stockholdings, and the fact that the total payments to the groups were in accordance with the respective stockholdings of the groups is inconclusive. For the by-laws (Exh. 1) provided with great care for the division of duties and responsibility between the groups. All of these provisions as to

division of powers and duties between the holders of the two classes of stock held by the two families explain the provision for equality of aggregate compensation, and emphasize the relation of the payments to the services of these two family groups, between which the directorate and the important offices were so shared.

5. Conclusion.

This case is believed to be the first involving the deductibility of group compensation actually paid as such.

The Circuit Court of Appeals, however, has held it not to be such, and has considered and rendered its decision on the assumption that amounts paid to each of the individuals concerned were determined by the corporation as the fair value of her services alone, and that amounts paid to other employees pursuant to assignments were a proper and indeed the best basis on which to determine their reasonableness. It is submitted that this basic assumption is false, and should be corrected; that the petitioner is entitled to have the justice of its position judged by wholly different standards, after an approach to the problem wholly different from that made by the Board of Tax Appeals and the Circuit Court of Appeals; and that in this proceeding a decision by the highest Court of the principles governing the deductibility of group compensation, as applicable to the circumstances here presented, will not only correct the wrong done to this petitioner, but will afford needed guidance in a realm thus far uncharted, and will therefore serve the public interest.

Respectfully submitted,

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